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Economic Development for Central America (U)

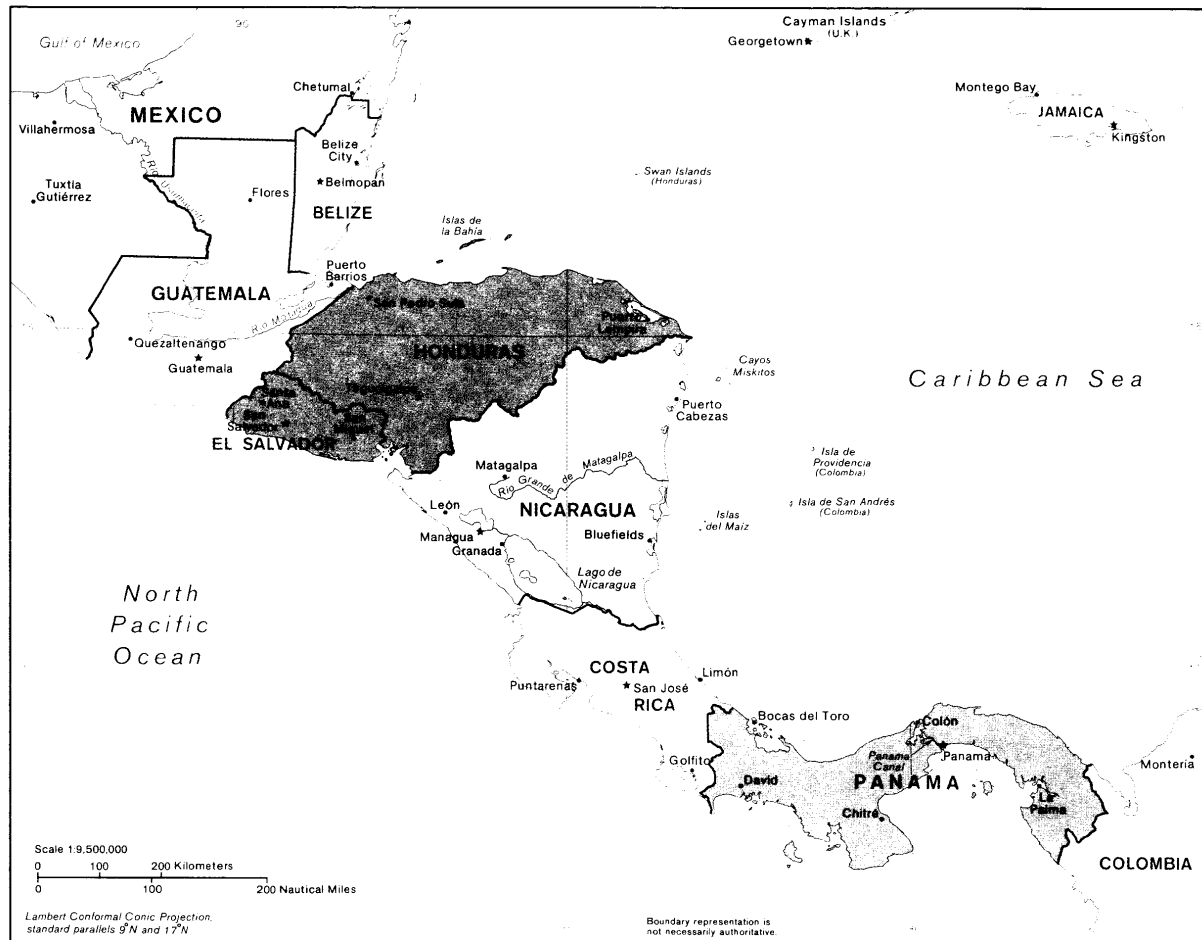
**NSSD 2-85
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Central America



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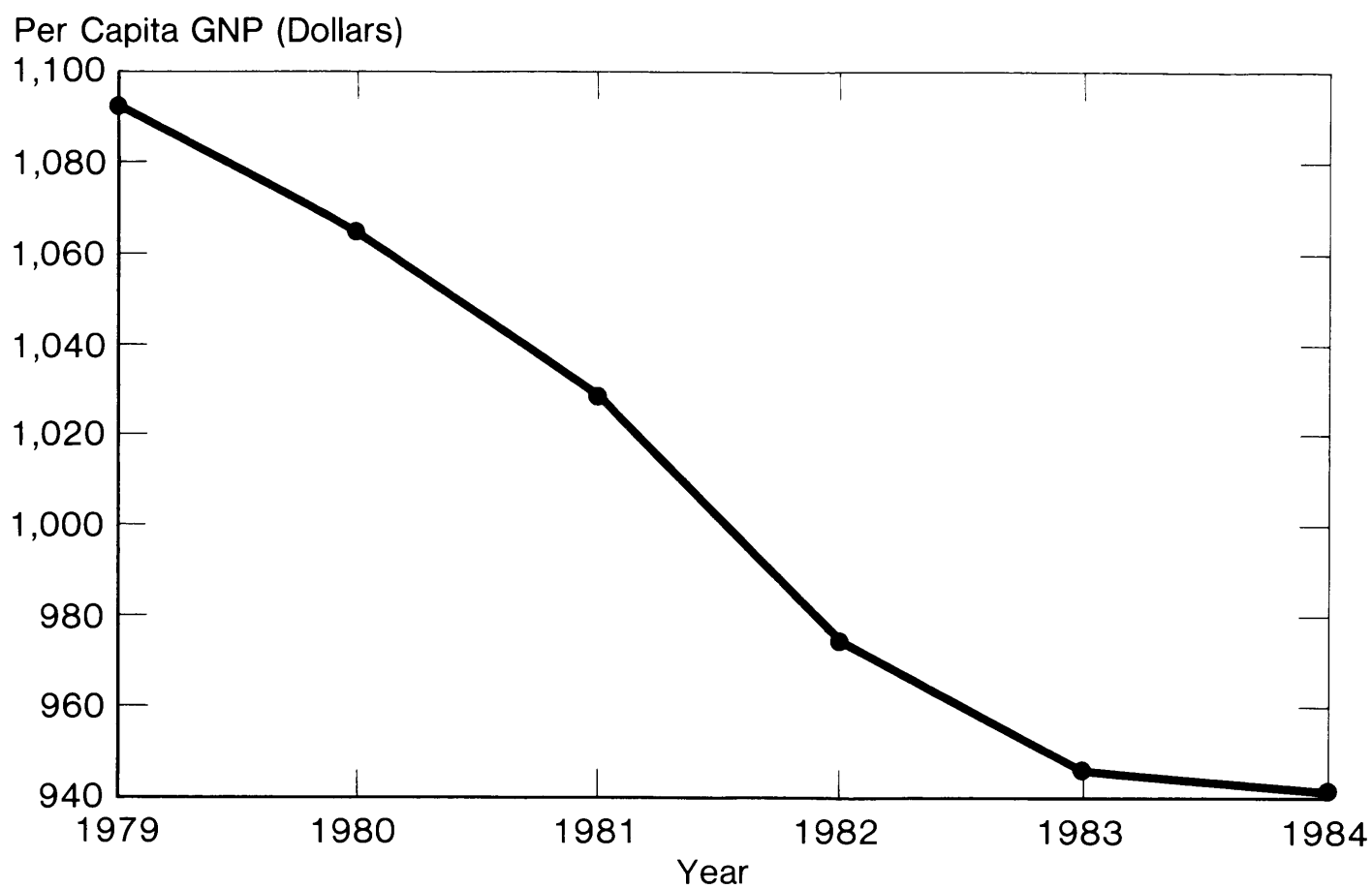
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Summary and Conclusions

1. Good progress is being made in implementing the Central American Initiative recommended by the Kissinger Commission a year ago. The principal objectives we seek through economic assistance -- rapid growth through exports and private investment -- are still appropriate.(U)
2. Central America is in the initial stages of an economic recovery, fueled by the increased U.S. economic assistance, an improving political climate, better policies and world economic recovery.(U)
3. Because progress toward regional peace has been less than hoped for, the region is still unlikely to achieve the economic goals set by the Commission. The region holds little interest for foreign investors, and even Central American entrepreneurs are hesitant to invest. Consequently, per capita incomes in Central America are unlikely to even return to the pre-crisis level by 1990.(S)
4. We reaffirm the need for the \$8.4 billion five-year assistance package recommended by the Bipartisan Commission a year ago. The trade credit guarantee program should be extended until the security situation has improved sufficiently to restore private credits. Up to now, we have received most of what we requested, but increased efforts may be needed in the future to assure adequate funding.(S)
5. The United States is shouldering the great bulk of the assistance burden in Central America, followed by the multilateral banks. Very little assistance has been forthcoming from Europe or Japan. We will want to monitor the contributions of other donors carefully.(S)
6. Economic stabilization assisted by the IMF is important to Central American governments: it generates additional amounts and sources of financial flows, and it promotes more efficient resource use.(U)
7. The security situation remains threatening, increasing the difficulties of implementing our economic assistance program. Governments are reluctant to adopt unpopular measures in an unstable political environment. Yet improved economic policies -- which usually have some short-term political costs -- are, in addition to political stability, the key to the effectiveness of our aid and to rapid economic growth.(S)
8. This dilemma of tradeoffs between our economic and strategic objectives will continue to pose difficult choices for U.S. policymakers. Close coordination among U.S. Government agencies will be important in properly balancing these objectives to achieve an optimal mix. This is likely to require increased policy-level discussion.(S)

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The Decline in Per Capita Income



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2. Central America: The Economic Backdrop

Since 1978, Central America has been buffeted by security threats, declining regional trade, the loss of international credits and foreign investment, and erosion of business confidence. (S)

These events have been mutually reinforcing, with political turmoil leading to loss of confidence, capital flight, and economic decline, which then increases political turmoil.

- Insurgency has seriously damaged much of the productive infrastructure in El Salvador. Even now, road transportation, electrical transmission systems, and dams are regular targets of the insurgents, and intimidation of rural workers has cut into agricultural production and exports.
- The region has been too risky politically and economically to attract external financial flows.
- Inadequate economic policies used to strengthen political support have fueled inflation and discouraged investment in export and other industries.
- The economically and politically risky environment has spurred capital flight to safe havens in the United States and elsewhere.
- Tourism has declined dramatically as a source of foreign exchange. (S)

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KEY QUOTES FROM THE BIPARTISAN REPORT

". . . whatever the costs of acting now, they are far less than the long-term costs of not acting now." (U)

". . . the intrusion of aggressive outside powers exploiting local grievances to expand their own political influence and military control is a serious threat to the U.S. and to the entire hemisphere." (U)

"Ultimately, the effectiveness of increased economic assistance will turn on the economic policies of the Central American countries themselves. . . . We agree with what many experts have told us: that unless these reforms are extended economic performance will not improve, regardless of the money foreign donors and creditors provide. In too many other countries, increased availability of financial resources has undermined reform by relieving the immediate pressure on policy makers. This must be avoided in Central America." (U)

". . . the crisis in Central America cannot be considered in solely economic or political or social terms. The requirements of the development of Central America are a seamless web." (U)

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3. Highlights of the Bipartisan Report

The report of the National Bipartisan Commission on Central America, chaired by Henry Kissinger, concludes that the current crisis is the result of the failure of political systems in Central America during the early 1970s to become more open in line with economic progress and a rise in political consciousness. The 1979 oil price increases, Cuban-Soviet-Nicaraguan intervention, and the world recession then overburdened the weak political institutions. (U)

The Report has two principal recommendations:

--The security situation must be improved through substantially increased military assistance to help El Salvador win the war and negotiation with or isolation of Nicaragua.

--An \$8.4 billion economic assistance program should be launched to address the interdependent economic, political and social problems facing the region. Three elements are involved: creating sustainable economic growth; building democratic political structures; and attacking extreme poverty. (U)

Other Recommendations

--Support for Export Development through financial support for export and investment promotion in the region and reduced U.S. trade barriers.

--Scholarships to bring 10,000 Central Americans to the United States over five years, a level of effort comparable to that of Soviet-bloc governments.

--Creation of CADO, the Central American Development Organization, an umbrella organization to oversee the progress of economic, social and political reforms in the region and to control one-fourth of the total U.S. assistance for the region.

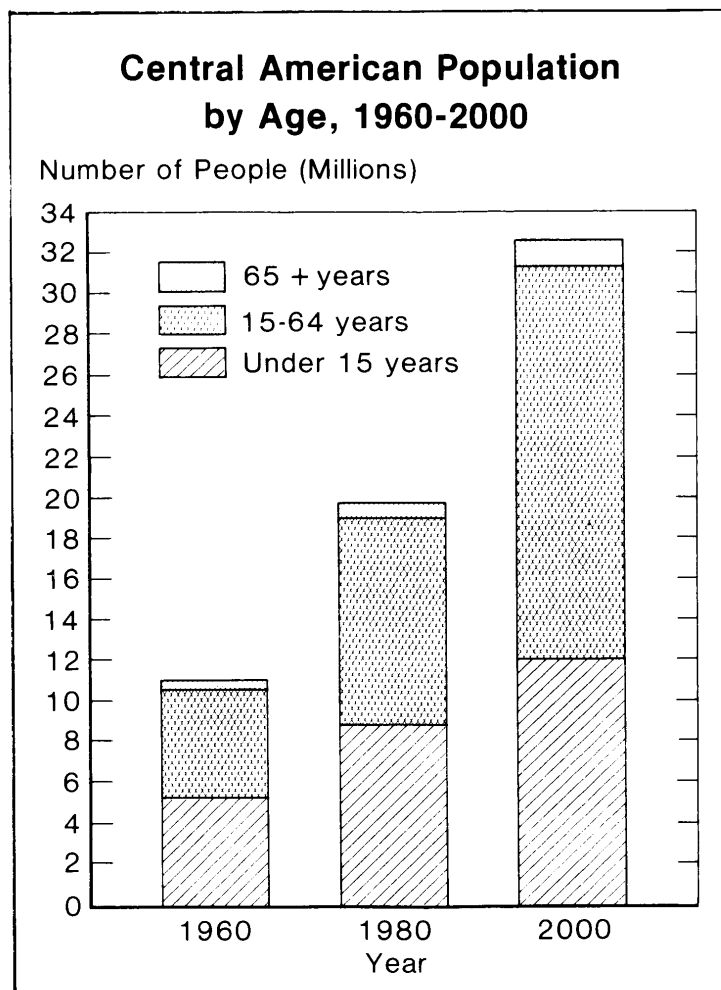
--Accelerated Health and Education Programs including use of Peace Corps Volunteers for literacy and teacher training, expanded technical education, new approaches to health programs, and expanded family planning programs.

--Strengthened Judicial Systems. (U)

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Major Goals of the Central American Initiative

Target Concern	1984 Level	1990 Goal
GNP Growth Rate	1.2%	5-6%
Agricultural Production Growth	0%	4%
Manufactured Exports to the U.S.	\$314 million	\$950 million
Infant Mortality (per 1,000)	65	50
Primary School Enrollment (%)	80%	95%
Family Planning Prevalence (% of Fertile Women)	24%	40%



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4. U.S. Economic Assistance Strategy in Central America

Based on the diagnosis of the Kissinger Commission Report, the U.S. Government has developed a four-pronged strategy. The program would achieve major social and economic goals; it would also address the massive increase in the labor force over the next 15 years that is the legacy of high birth rates during the past two decades. (U)

--Economic Stabilization. The essential first step is to stop the downward spiral in production, incomes and employment by policy reforms to halt capital flight and by financing necessary imports. This buys time for the governments to establish sustainable development strategies. (U)

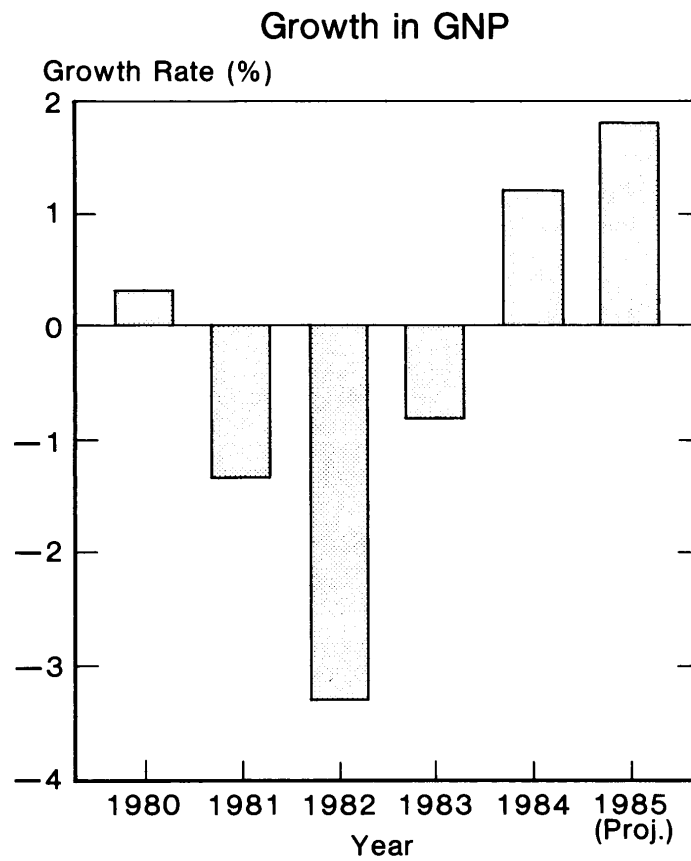
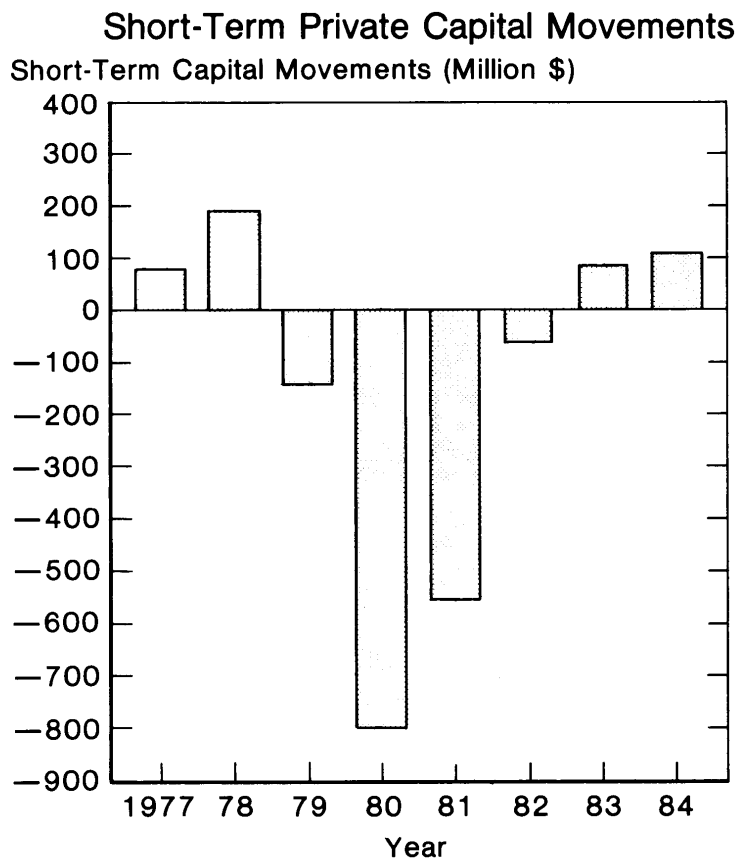
--Economic Transformation. Over the medium term, the region's economy must be put on a self-sustaining basis. Production of labor-intensive agricultural and industrial products for export markets is needed. An export-led growth strategy requires changes in government economic policy -- broader opportunities for the private sector, an end to excessive regulation, appropriate exchange rates, major investments in productive enterprises and in economic infrastructure, and development of indigenous energy resources to reduce the burden on imports. (U)

--Broadening the Base. In Guatemala, El Salvador and Honduras, disparities in income and opportunity are so wide that a direct attack on poverty is needed. Increasing primary school enrollments to all primary-aged children, sharply reducing infant mortality, increasing access to modern family planning, and improving access to agricultural technology are all necessary. (U)

--Democratic Institutions. Democratic institutions should be promoted through strengthening of judicial administration, support for fair elections, and increased understanding of U.S. institutions through scholarships for U.S. education. The planned 10,000 scholarships for U.S. study during the next five years would raise U.S. support to the level of the Soviet-bloc countries. (U)

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Encouraging Signs of an Economic Turnaround in Central America



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5. U.S. Assistance Has Produced Some Encouraging Signs

The buildup of U.S. economic assistance to Central America, coupled with economic reforms and an improved international economy, has begun to yield positive results on both the economic and political fronts. A vicious circle of worsening economic conditions and political instability was halted in 1984, when the region had positive economic growth for the first time in four years. There is also an encouraging movement toward democracy in the region. (S)

--Economic Stabilization. After plummeting steadily over the 1979-83 period, gross national product grew by 1.2% in 1984 in the Central American countries we are supporting -- the highest in five years. U.S. assistance and economic reforms were the key elements in this turnaround -- both through the financial resources we provided and through the increased confidence in political and economic stability that our support generated. Private sector confidence is also returning, as evidenced by short-term private capital movements -- which became positive in 1983 and 1984 after large amounts of capital flight in the previous three years. Much more remains to be done, but progress has been made in policy reform:

--exchange rates in Costa Rica, El Salvador and Guatemala have been realigned to encourage exports;

--government budgets have been reduced and fiscal deficits cut in Costa Rica;

--government controls inhibiting private sector investment have been reduced; and

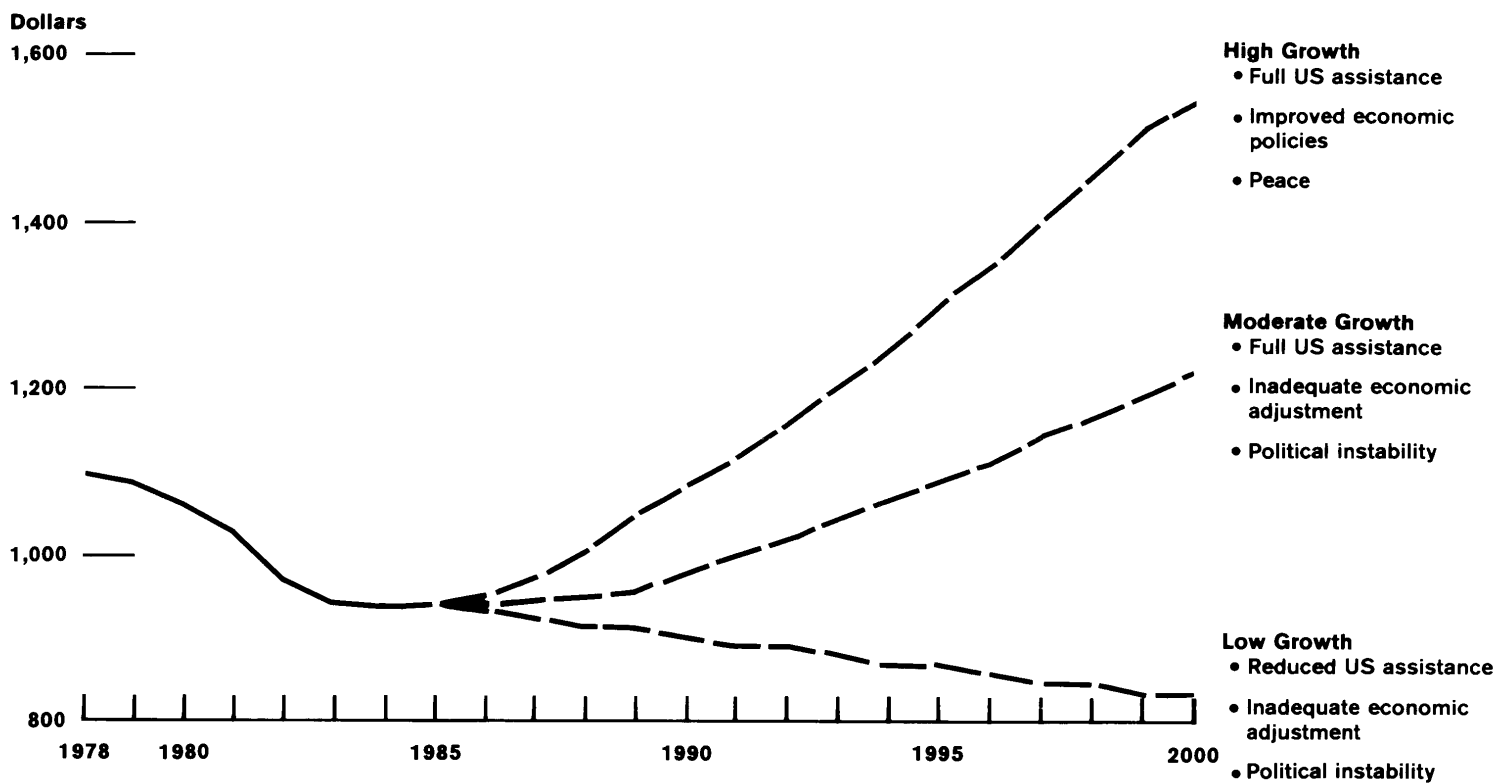
--governments are actively considering divestment of inefficient public enterprises through sale to the private sector, particularly in Costa Rica and Panama. (S)

--Political Stabilization and Democratic Institutions. Considerable progress has been made toward strengthened democratic institutions. Only Costa Rica and Belize have solid traditions of democratic government in the region, but significant positive progress has occurred in each of the other countries supported by U.S. assistance. El Salvador and Panama have both completed democratic elections for president after a decade or more of military rule. Guatemala, where a constituent assembly has been writing a new constitution, may make this transition later in 1985. In Honduras, a democratically-elected government is expected to complete its term next January and turn power over to another democratically-elected government -- the first peaceful transition of power there in three decades. (S)

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Central America: Per Capita Income Trends



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6. Illustrative Economic Growth Paths

The Kissinger Commission made four key assumptions:

- OECD economic growth of 3-4%, with higher growth in the United States.
- high levels of U.S. assistance.
- economic policy reform by Central American governments to increase private sector investment and exports.
- declining violence, followed by peace within the region within 1-2 years.(U)

There are three critical variables which will affect growth:

- the presence or absence of peace;
- the level of foreign assistance; and
- economic policies of the region's governments.(U)

With these variables, several alternative growth paths are possible:

○ High Growth. A combination of high levels of U.S. aid, major reforms in local economic policy and a reversal of Managua's aggressive regional stance could provide rapid economic growth. This outcome would require strong commitment to market-oriented economic policies to stimulate financial flows and private investment, particularly in non-traditional export sectors. (S)

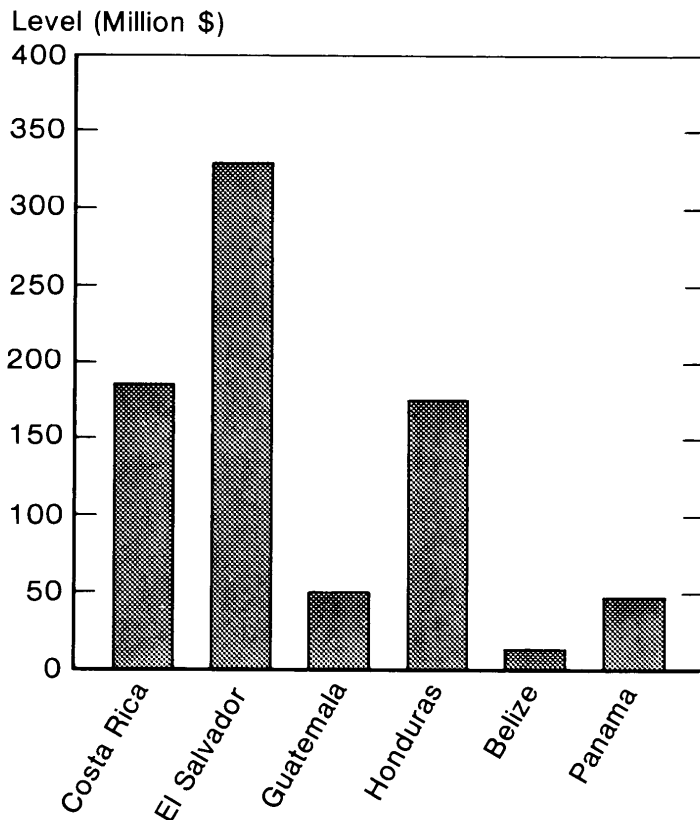
○ Moderate Growth. A combination of high levels of U.S. aid, inadequate economic reforms and political instability will lead to only moderate growth in per capita incomes. The lack of stabilization programs would reduce net financial flows from other sources, including debt rescheduling. It would be the mid-1990s before the 1978 level of per capita income was re-established. (S)

○ Low Growth. Without the Jackson Plan U.S. assistance, a continuation of current policies would be likely to lead to a continued downhill slide in per capita income. Because of the likely political unrest and poor economic climate, potential foreign investors or commercial lenders would be generally unwilling to provide resources to the region, and capital flight would continue. (S)

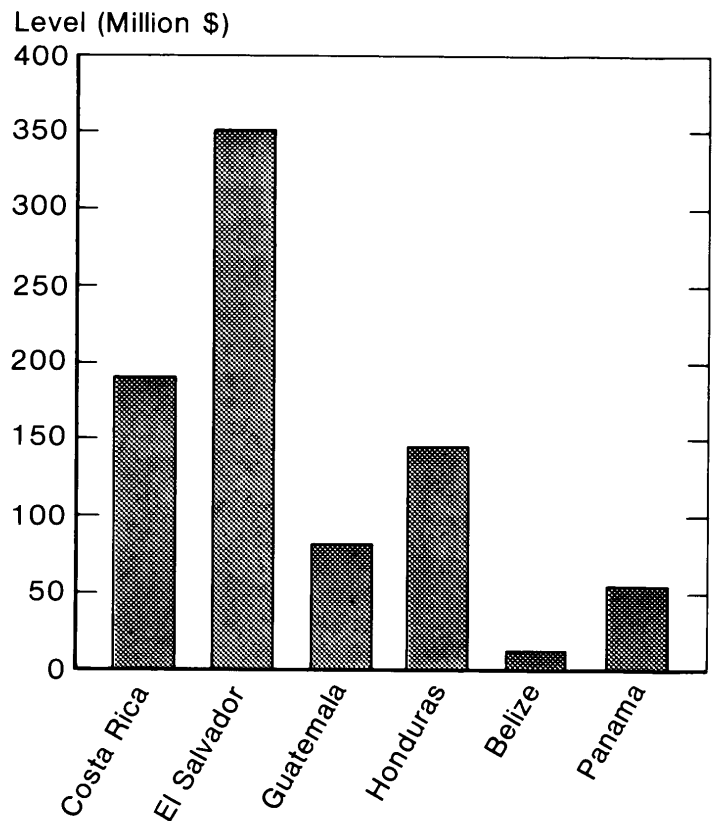
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U.S. AID Allocations by Country (Million Dollars)

Actual FY 1984



Requested FY 1986



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7. Allocation of U.S. Economic Assistance

--The total amount available for the region is set both by our estimate of the need (based on balance of payments gaps and absorptive capacity) and the constraints imposed by the U.S. budget. Allocations among countries must reflect relative needs, each government's commitment to sound policy, and its willingness to cooperate with us on broad goals, both economic and political, that will ensure security. Thus, the relative levels are not absolute rankings of the importance of each country to the United States. (U)

Our current assistance levels illustrate the criteria used:

--El Salvador and Costa Rica received the largest shares of the total because their economies were in the greatest danger of collapse -- El Salvador because of the insurgency, and Costa Rica because of a massive foreign debt. (U)

--We have judged that democratic Costa Rica also deserves continuing support to reward their progress -- the most significant in the region -- in adopting and implementing the free-market reforms we advocate for sustained economic growth. (U)

--Honduras receives less because its needs and absorptive capacity are less, even though the country is highly cooperative on security matters. (U)

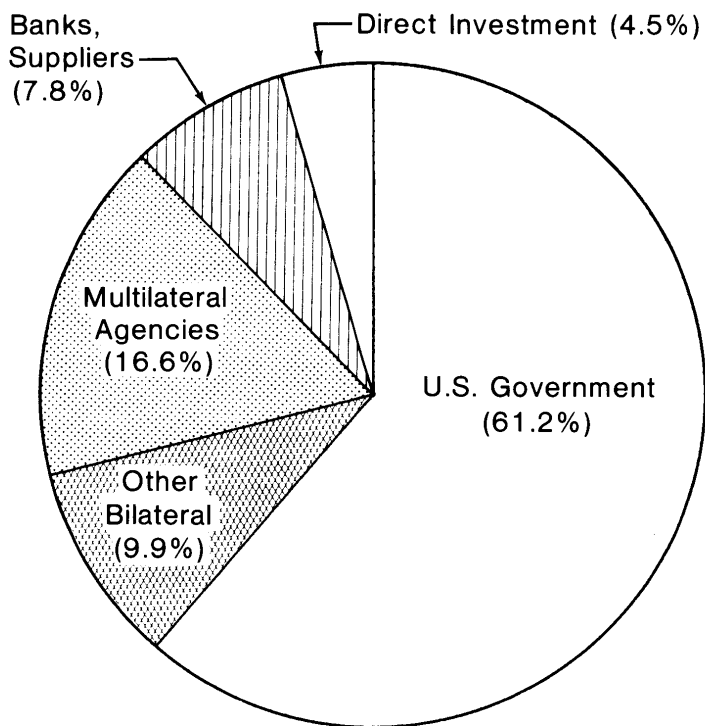
--Aid to Guatemala has been constrained by Congressional concerns over the human rights record of the successive military governments, and a lack of strong economic policies. (U)

--Assistance to Panama and Belize has increased markedly under the Central American Initiative, albeit less than to the Core Four, because of lower immediate need, higher living standards and lesser threats to their security. (U)

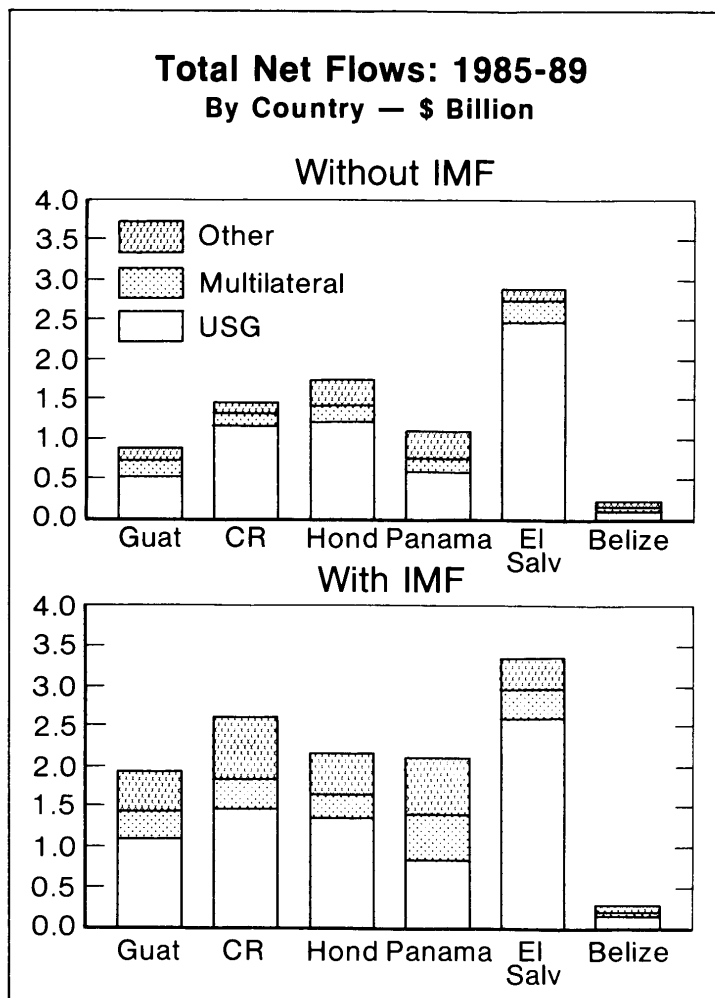
--Nicaragua, of course, receives no U.S. economic aid because of its relationship with the Soviet bloc and its adoption of marxist and statist economic policies. Should these circumstances change, our aid policies would change accordingly. (U)

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Projected Sources of Net Financial Flows to Central America, 1985-89



Note:
This Projection Assumes Agreements With the IMF.



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8. The U.S. Faces Potentially Difficult Choices in Central America

The major vehicle for assisting Central American governments -- economic aid -- could be the means by which they can postpone difficult steps. We therefore sometimes face problems in effectively using our economic assistance. Moreover, governments in the region may view our economic assistance as payment for their role in supporting U.S. strategic or political objectives rather than as conditioned economic aid. (S)

An International Monetary Fund-supported program is the best assurance of an adequate short-term economic adjustment program and of the availability of funding from other sources. However, implementation of the economic reforms associated with IMF programs is sometimes politically unacceptable to the government in question. Since the U.S. Government is deeply concerned about political stability in the region, we face difficult decisions regarding the level of conditionality we believe is achievable. U.S. policymakers need to make careful assessment of, and conscious decisions about, the likely consequences for various interrelated U.S. objectives. (S)

In the recent past, our policy responses have tended to fall into three categories:

--An IMF Agreement. We have generally sought to provide balance of payments assistance in support of IMF programs. Structural reform conditions are often included as well. (S)

--Set our own conditions. Where conditions have precluded an IMF agreement, we have continued to disburse funds in some cases, using our own conditions to ensure their effective use. This approach involves two complications:

--the U.S. can be seen as imposing onerous conditions on our aid, thereby potentially damaging bilateral relations.

--lack of an IMF program would mean foregoing other resources. Over the next 5 years, the net cost to the Central American countries with no IMF programs is estimated to be as high as \$4 billion, or 30% of projected net flows to the region. (S)

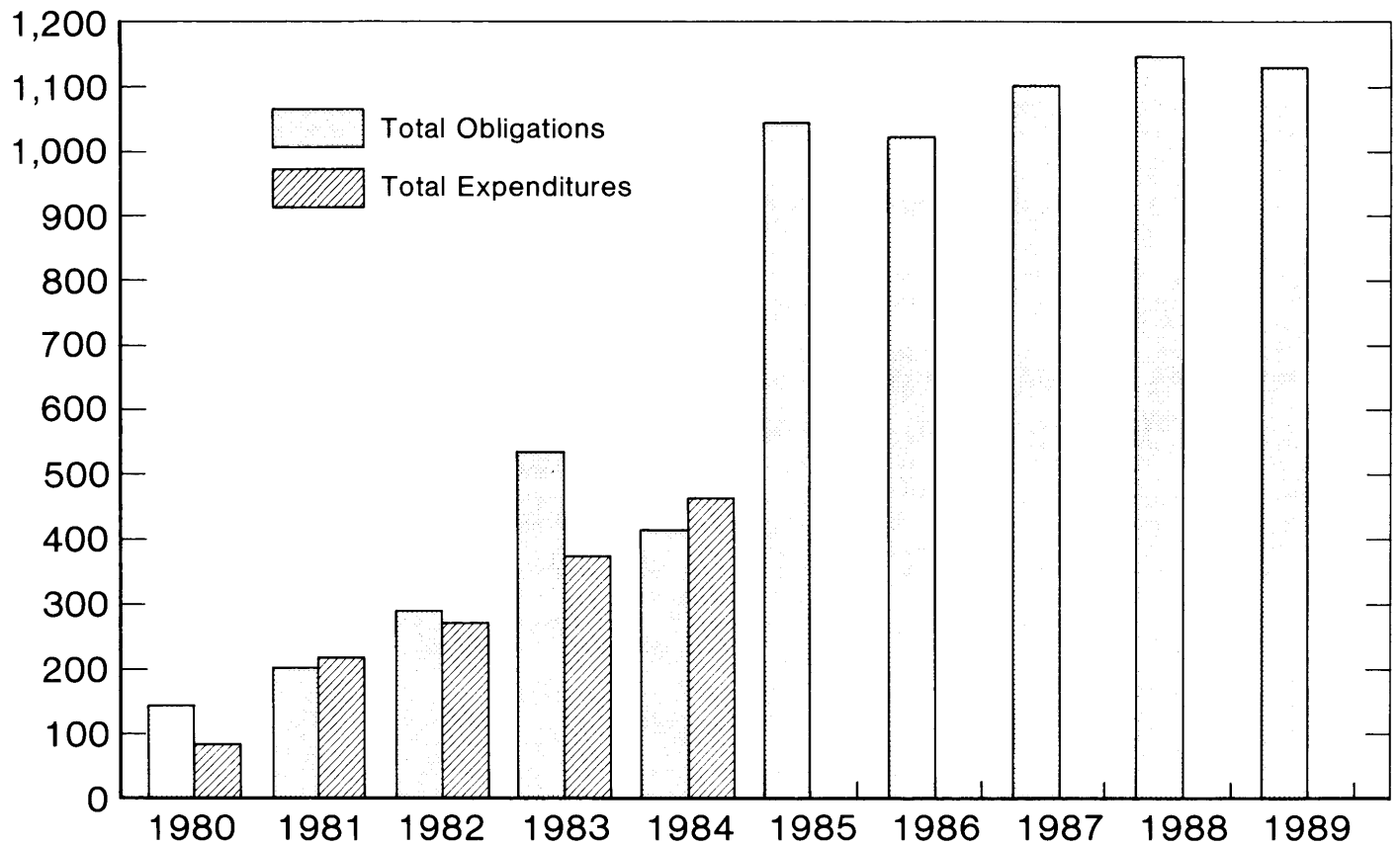
--Waive conditionality. This alternative maintains the best bilateral relationship, and goes furthest to support political stability in the short run. However, lack of needed economic reforms may slow growth, which will tend to increase dependence on U.S. support and could threaten long-term political stability. (S)

No single choice is likely to produce an ideal outcome. Therefore, there will be a continuing need to tailor our conditionality to the specific factors at play in any given country, including the political and security environment. Getting the mix right is likely to require considerable understanding of the tradeoffs and attention at the policy level. (S)

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U.S. Economic Assistance—Central America (Obligations & Expenditures by FY)

Millions of Dollars



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9. Implementation, Timing and Monitoring of Assistance Programs

--Economic progress in Central America demands a long-term commitment.

--Implementation of the President's Central American Initiative is presently being carried out primarily by AID. Program proposals are developed in the field and reviewed in Washington by an interagency group.

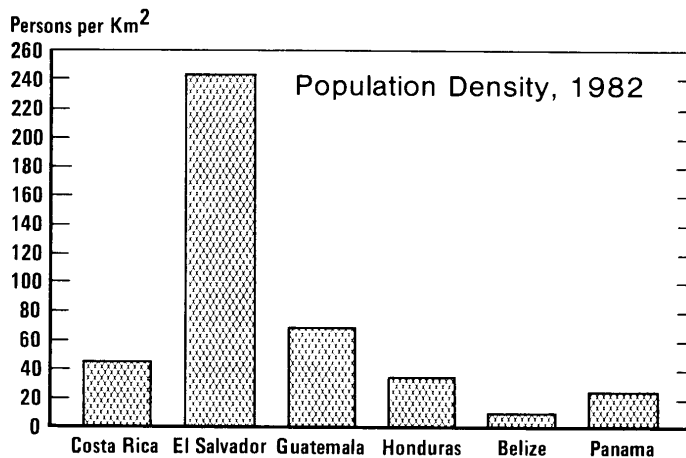
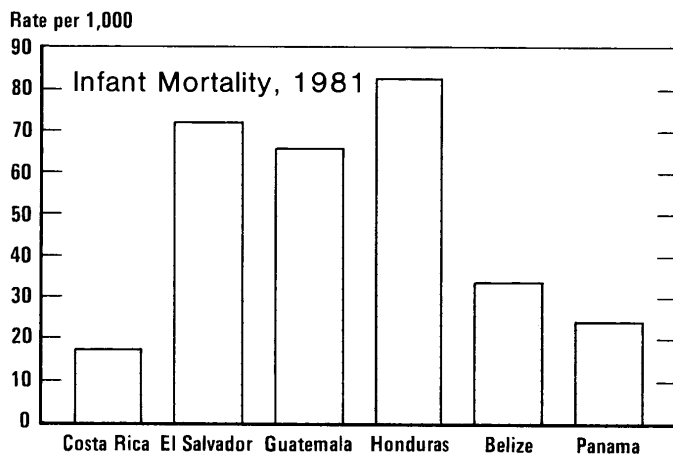
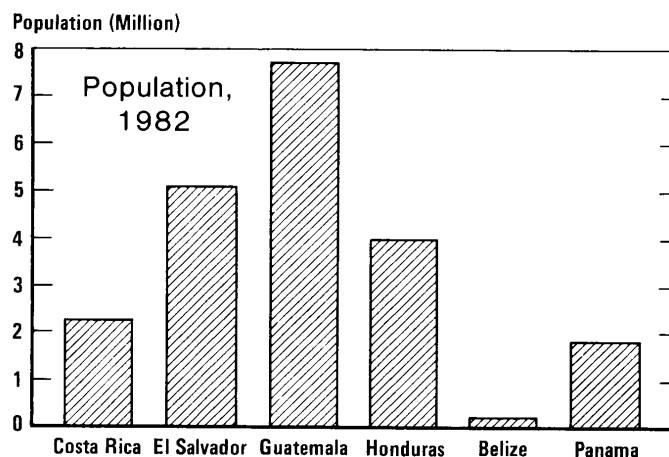
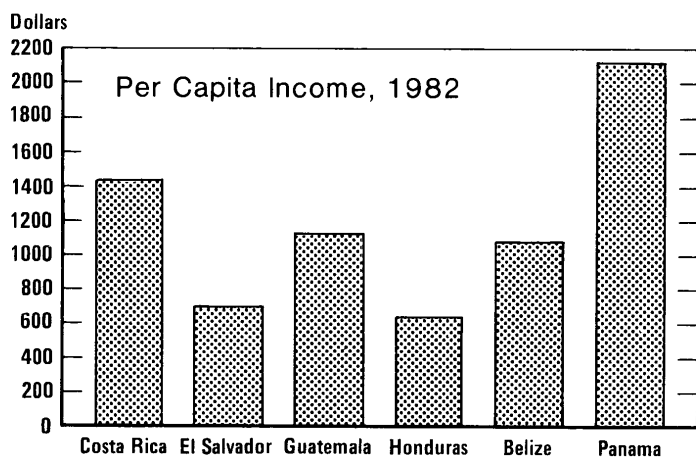
--A two-tier computer tracking system is being developed to monitor implementation and progress toward the achievement of our Central American goals. These efforts help to track progress toward our long-term economic and political objectives.

--To assure that policy issues relating to assistance requirements are met, a special ad hoc group chaired by AID and State has been created.

--This NSSD underscores the need for timely and systematic review of both ongoing and ad hoc funding requirements. (S)

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Economic and Social Indicators for Central America



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10. Country Profiles

Central America is usually treated as largely homogenous. Yet diversity and uneven progress among the countries are historical facts. For example, infant mortality in Costa Rica, Belize, and Panama is at the level of the United States during the early 1970s; for the rest of Central America, the rate parallels that in the United States a half-century earlier. (U)

Costa Rica has had a long tradition of democratic government, mass education, and stability. Excessive borrowing during the late 1970s fueled massive growth in the public sector, creating a financial crisis. The government has come to grips with this problem and is divesting government enterprises. Nevertheless, working off the debt overhang will require most of the rest of the decade. (U)

El Salvador is the smallest and most densely-populated country. The country grew rapidly during the 1960s and the political system appeared to be opening, but most of the progress was reversed after 1973. (U)

Guatemala has the largest population of any Central American country, and the largest industrial sector. Nevertheless, it also has great cultural divisions between the largely Indian highlands (many Indians do not speak Spanish) and the rest of the society. Governments have tended to be conservative and to lack a development orientation. (U)

Honduras is the poorest of the countries. Though having ample land and other natural resources, lack of human resources and leadership have gradually widened the gap between Honduras and the other countries. (U)

Belize, originally a British enclave, is a sparsely-populated country with a solid democratic tradition, and high education and health standards. With a large resource base, its economic problems are the least severe of any of the countries in the region. (U)

Panama is a middle-class country that has gradually emerged as a Latin American banking and service center. The current government is addressing the foreign debt and bloated public sector that pose the most serious challenges to economic recovery. (U)

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ANNEX

ECONOMIC ASSISTANCE TOOLS OF THE U.S. GOVERNMENT

--ESF. Economic Support Funds, the most flexible form of U.S. assistance, are usually not tied to specific projects; allocations are determined by U.S. security interests, but usually tied to economic reforms by the recipient.

--DA. Development Assistance funds administered by AID are for specific development projects, mainly in agriculture, health, education and family planning.

--PL 480. PL 480 provides grants and long-term loans at concessional interest rates for purchase of U.S. agricultural commodities.

--CCC. The Commodity Credit Corporation provides guarantees for 3-year credit at near-market interest rates. The purpose is market development for U.S. agricultural exports.

--Eximbank. The Export-Import Bank provides short and medium-term insurance and guarantees at near-market rates of interest to promote U.S. exports.

--MDBs. Multilateral Development Banks draw funds from the U.S. and other governments and raise funds in capital markets, using member-government guarantees, to provide long-term finance, primarily for development projects.

--IMF. The International Monetary Fund provides temporary balance of payments assistance in conjunction with stabilization programs.

--Paris Clubs. Rescheduling, or postponement of repayment, of debts to the U.S. government -- done in concert with other bilateral creditors -- provides breathing space to governments facing imminent default. An IMF agreement is a precondition for such reschedulings. (U)

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